

**Economic Reconstruction During War-Time: Academic Perspectives For
Assisting Marine Efforts at Providing Stability to Iraq**

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Introduction

In a significant policy statement¹ released toward the end of 2005 the United States outlined its strategy for victory in Iraq. Victory is defined in terms of a sequential set of completed goals: (1) Short term, Iraq is making steady progress in fighting terrorists, meeting political milestones, building democratic institutions, and standup security forces; (2) Medium term, Iraq is in the lead defeating terrorists and providing its own security, with a fully constitutional government in place and on its way to achieving its economic potential; and (3) Longer term, Iraq is peaceful, united, stable and secure, well integrated into the international community and a full partner in the war on terrorism.

The US strategy is essentially three pronged: developing democracy, providing security and reviving the economy. In the economic area U.S. and coalition efforts have focused on helping Iraq restore the country's neglected and damaged infrastructure with the goal of restoring and expanding essential services. Other objectives include: the creation of a market based economy, and greater transparency and accountability in the public sector.²

The logic of this strategy is straight-forward:³

1. The rebuilding of Iraq's infrastructure and the provision of essential services will increase the confidence of Iraqis in their government and help convince them that the government is offering a brighter future. People will then be more likely to cooperate with the government and provide intelligence against the enemy, creating a less hospitable environment for the terrorists and insurgents.

¹ National Strategy for Victory in Iraq (Washington: National Security Council, November 2005).

² Ibid., p. 22.

³ Ibid.

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2. Efforts in the reconstruction realm have significant implications in the security realm when they focus on rebuilding post-conflict cities and towns. Compensations for civilians hurt by counterterrorism operations and the restoration of some economic vibrancy to areas formerly under terrorist control can help ease resentment and win over an otherwise suspicious population.
3. Economic growth and reform of Saddam-era laws and regulations will be critical to ensuring that Iraq can support and maintain the new security institutions that the country is developing, attract new investment to Iraq, and become a full, integrated member of the international community.
4. Economic growth and market reform – the promotion of Iraq's private sector – are necessary to expand job opportunities for the youthful Iraqi population and decrease unemployment that makes some Iraqis more vulnerable to terrorist or insurgent recruiting.

While this strategy has many merits, it is basically a continuation of the long term approach taken by Ambassador Bremer and the Coalition Provisional Government (CPA) in 2003. Subsequent to the release of the NDS Ambassador Bremer expressed reservations over the course he set out for Iraq's economic recovery:

We also placed too much emphasis on large-scale reconstruction projects. While the urgent need for modern highways, electrical generating plants and the like was clear, we should have anticipated that building them would take a long time. Our earlier efforts should have been directed more tightly at meeting Iraqis' day-to-day needs.⁴

Iraqis themselves are increasingly skeptical of the ability of this strategy to produce lasting economic gains and a semblance of stability. Certainly the ability to complete infrastructure projects on time and within budget has proven to be a nearly impossible task. As noted by the U.S. Inspector General for Iraq Reconstruction infrastructure programs in that country have been plagued by "violence, corruption and mismanagement."⁵ As a result "the ambitious US reconstruction effort in Iraq is likely to fall far short of its goals because soaring security costs and poor management have slashed the amount of American money available for rebuilding projects."⁶ Just as serious is the all

⁴ L. Paul Bremer, "In Iraq, Wrongs Made a Right," New York Times, January 13, 2006.

⁵ Quoted in Tom Regan, "US Inspector General for Iraq Paints 'Grim' Picture of Reconstruction Effort," Christian Science Monitor, November 1, 2005.

⁶ Ibid.

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too apparent long lead time before any tangible benefits in terms of improved living standards are seen by the average Iraqi.

Implicit in Ambassador Bremer's assessment is that the main flaw in the US strategy has been its inability to deliver short-run economic gains to large segments of the Iraqi population. Unfortunately the NDS does little to address this issue, and appears content simply continuing the existing strategy.

Specifically, other than noting that oil revenues will assist in financing infrastructure and much of the country's capital expenditures, the NDS does not explicitly address the role of oil in Iraq's future. Yet there is a vast literature suggesting that the oil sector and the allocation of its revenues is *the* critical variable in shaping both the economic structure and political systems of countries like Iraq. For the most part this literature focuses on the so called "oil curse" or the "paradox of plenty."⁷ These colorful phrases capture the gist of oil's potentially destructive powers -- unless properly managed oil revenues more often than not undermine the economic, political and social fabric of countries irrespective of how well intended their long run goals and objectives. The result is often the creation of a rentier state mired in corruption, economic mismanagement, and authoritarianism.

Also complicating Iraq's recovery is the fact that we still don't have a complete picture of the contemporary dynamics of the Iraqi economy. Clearly factors such as the "brain drain," the lack of commercial credit⁸ together with uncertainty due to the security situation have largely brought investment in the formal segments of the economy to a halt⁹.

A third of Iraq's professional class is reported to have fled to Jordan, a flight of skills worse than under Saddam. UN monitors now report 2,000 people a day are crossing the Syrian border. Over a hundred lecturers at Baghdad University alone have been murdered, mostly for teaching women. There are few places in Iraq where women can go about unattended or unveiled. Gunmen arrived earlier this month at a Baghdad television station and massacred a dozen of the staff, an incident barely thought worth reporting. The national museum is walled up. Electricity supply is down to four hours a day. No police uniform can be trusted. The arrival anywhere of an army unit can be prelude to a mass killing

⁷ Terry Lynn Karl, *The Paradox of Plenty: Oil Booms in Petro-States* (Berkeley: University of California Press, 1997).

⁸ Cf. Robert Looney, "Building from Scratch: The Transformation of Post-War Iraq's Financial System," *Middle East Policy* 12:1 (Spring 2005), pp. 134-149.

⁹ "Unemployment Caused by Insecurity and Vice-Versa," *IRINnews.org* (November 29, 2004).

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All intelligence out of Iraq suggests this is no longer a functioning state.¹⁰

Yet, from antidotal accounts¹¹ there are indications that many areas of the shadow economy are prospering and, as during the period of sanctions, successfully adapting to the harsh environment. On the other hand, the shadow economy has provided a boon to criminal gangs and a major source of funding for the insurgency.¹²

With these themes in mind, the purpose of the sections that follow is to examine the means by which the economy can contribute toward building a viable new Iraq. First, an assessment is made of key issues surrounding the economy: (a) what were the initial obstacles to the economy's reconstruction? (b) The approach taken towards the economy in the post-war period? (c) The major accomplishments and failures? (d) The lessons learned? (e) How has the development of the economy assisted the insurgents and criminal groups? Second, this assessment of Iraq's economic progress to-date suggests several key areas as critical to the success of Marine efforts at stability operations and nation building in Iraq. A final section outlines a broad economic strategy that the Marines might consider in assisting their efforts to bring stability to the al Anbar region.

To this end, the following sections draw on a wide range of on-going research conducted at the Naval Postgraduate School. In particular.

- The size, expansion and implications of Iraq's informal economy incorporating theories of corruption – The business of insurgency.¹³
- Economic Reforms and Efforts at reconstruction drawing on the experience Eastern Europe and the former Soviet Union – Dynamics of vicious and virtuous circles.¹⁴

¹⁰ Simon Jenkins, "America Has Finally Taken on the Grim Reality of Iraq," *The Guardian*, October 18, 2006

¹¹ For example: David Hecht, "Why War Zones Love Monopolies," *Fortune* 149:11 (May 31, 2004), p. 66; Jeffrey Fleishman, "In the New Baghdad, Viagra a Hot Sell," *Los Angeles Times*, June 17, 2004; Stanley Reed, "The Kurds Embrace a New Cause: Rivals are Uniting Behind Economic Development in the Northern Iraqi Region," *Business Week*, January 12, 2004, p. 48.

¹² Robert Looney, "The Business of Insurgency: The Expansion of Iraq's Shadow Economy," *The National Interest*, Fall 2005.

¹³ Robert Looney, "Economic Consequences of Conflict: The Rise of Iraq's Informal Economy," *Journal of Economic Issues*, XL:4, December 2006; Robert Looney, "The Business of Insurgency: The Expansion of Iraq's Shadow Economy," *The National Interest* 81, Fall 2005

¹⁴ Robert Looney, "Middle East Reform Initiatives: A Stage Theory Perspective," *International Journal of World Peace* 22:1 (March 2005); Robert Looney, "Reform Initiatives for Iraq and the Middle East: The Search for What Works," *Journal of South Asian and Middle Eastern Studies*,

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- The evolving nature of Iraq's insurgency employing theories of netwar.¹⁵
- The Use of Foreign aid/Assistance to combat terrorism/extremism/and terrorist recruitment.¹⁶
- Civil Society in Iraq.¹⁷
- Third Generation Gangs and Insurgencies¹⁸.

These separate bodies of research form the basis of a comprehensive framework (Figure 1) for understanding the evolution of the Iraqi insurgency. Drawing on the dynamics of this framework, the sections below are focused on identifying the critical role that the Marines can play in restoring order and economic prosperity to Iraq.

Efforts at Reconstruction

Even without the insurgency, Iraq's reconstruction would have been a monumental undertaking. As the NDS notes, Saddam Hussein's economic legacy will be present for some time. In particular, that regime's questionable economic policies, its mismanagement of the economy together with political repression, internal conflicts, wars and sanctions left a number of serious impediments to recovery and growth. Initial reconstruction efforts dealt largely with correcting and reversing the effects of these debilitating forces that had built up over the years:¹⁹

- Restoring government economic functions after looting and state collapse;
- Preventing currency collapse, hyperinflation and economic chaos;
- Rebuilding infrastructure ravaged by war, sanctions, looting and neglect;
- Rehabilitating a health care system cut off from medical advances for two decades;
- Dismantling corrupt, dysfunctional state economic controls; and

28:1 (Fall, 2004); Robert Looney, "The Economics of Iraqi Reconstruction," *Strategic Insights*, V:5 (May 2006).

¹⁵ John Arquilla and David Ronfelt eds., *Networks and Netwars: The Future of Terror, Crime and Militancy*, Santa Monica: Rand Corporation, 2001

¹⁶ Robert Looney, "Failed Economic Take-Offs and Terrorism in Pakistan: Conceptualizing a Proper Role for U.S. Assistance," *Asia Survey* XLIV:6 (November/December 2004).

¹⁷ Abbas Kadhim, "Civil-Military Relations in Iraq (1921-2006): An Introductory Survey," *Strategic Insights* V:5 (May 2006).

¹⁸ Nicholas I. Haussler, *Third Generation Gangs Revisited: The Iraq Insurgency*. Masters Thesis, Naval Postgraduate School, September 2005.

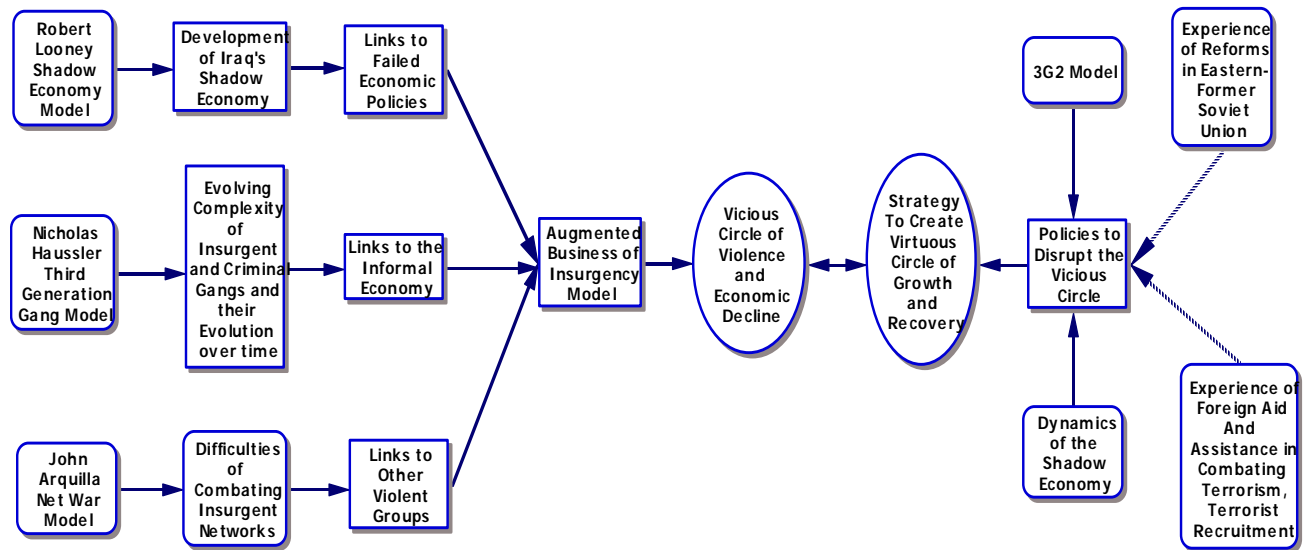
¹⁹ Anne Ellen Henderson, *The Coalition Provisional Authority's Experience with Economic Reconstruction in Iraq* (Washington: United States Institute for Peace, April 2005), p.3.

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- Stimulating the growth of a private sector that had been stunted by government interference.

Figure 1

Interaction of the Iraqi Economy and Insurgency



A number of major successes did occur, especially under the Coalition Provisional Authority (CPA). Major successes under the CPA included:

- Re-established nationwide food-ration system;
- Introduced a new currency and stabilized the exchange rate;
- Liberated most prices without igniting inflation;
- Rebuild the government's economic ministries;
- Promulgated market-oriented banking, taxation, foreign trade; investment, and business regulations;
- Rehabilitated several thousand schools, health clinics, and hospitals;
- Provided public services to populations that had been deprived under Saddam;
- Increased electrical generation and output; and
- Funded small projects across Iraq to meet critical community needs.

Still the Coalition's economic accomplishments were overshadowed by its unfulfilled promises. During the occupation the CPA failed or was unable to:

- Prevent rampant looting or infrastructure and production facilities;
- Attract foreign investment;

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- Implement its newly enacted economic regulations;
- Restructure state-owned industries;
- Fulfill promises of substantial job creation;
- Meet targets for electricity production (despite increases);
- Restore oil output to prewar levels;
- Eliminate costly distorting energy and food subsidies;
- Combat corruption in reconstruction projects; and
- Spend more than a fraction of the \$18.4 billion the U.S. Congress allocated for Iraq's reconstruction.

Clearly, post-war economic progress has been disappointing. While a number of economic obstacles and distortions are lessening as a result of the reforms²⁰ put in place by the Coalition Provisional Authority (CPA), others were created or reinforced through post-war policy errors and miscalculations.²¹ The net result is an economy whereby²²:

1. The oil sector dominates the economy, accounting for around 74% of GDP. Iraq now depends solely on oil exports for finance of investment and consumption expenditures, for government revenues – of which oil export proceeds exceed 93%, and for 98 percent of foreign currency earnings.
2. Centralized decision making and intrusion of the state into economic life have distorted the pricing structure in many key sectors. In particular prices of food and energy do not reflect the true costs of production. In turn, distorted prices have caused inefficiencies and waste.
3. The public sector is over represented in the economy, leading to inefficiency and decreased growth. Many state enterprises (SOEs) are currently dormant. The weakness of the private sector has limited its role in economic development, increasing the lack of diversification.
4. Social inequalities are widespread in a broad range of fields covering health, education, public services, social services to low-income groups, the disabled, internally displaced persons, refugees, single-parent households, and other vulnerable groups, across geographic areas.

²⁰ Cf. Robert Looney, "Iraq's Economic Transition: the Neoliberal Model and its Role," *The Middle East Journal* 57:4 (Autumn, 2003), pp. 568-587.

²¹ Documented in Robert Looney, "The Viability of Shock therapy in Iraq," *Challenge*, 47:5 (September – October 2004), pp. 86-103.

²² The Iraqi Strategic Review Board, *National Development Strategy 2005-2007* (Baghdad: The Ministerial Committee on The National Development Strategy, September 2004), pp. 3-4.

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5. With over 50% of the population under 24 years of age, rapid rates of population growth are likely for many years. Many in this large demographic group are alienated due to violence and limited access to education, training and career prospects.
6. Widespread unemployment, climbing to over 50% in some regions such as al-Anbar, combined with absolute poverty where more than 60% of the population depends on the government's rationed food basket have led to an increase in demands for social assistance.
7. Poor governance practices are common including widespread nepotism in public appointments and corruption among public servants. The lack of accountability and transparency in managing state resources has abetted corruption and increased its corrosive effect on growth and efficiency.
8. Iraq's decades long isolation has resulted in the digital divide, outdated institutions, administrative systems and know-how. Technological stagnation and the use of outmoded production methods have weakened the economy as a whole.
9. Public sector institutions have witnessed serious looting, theft and destruction.
10. Another legacy of the past was the total dependence on monetary expansion to finance the deficit in the budget, which led to an average inflation rate of 50% annually during the 1990s. While monetary policy is now on a sounder footing with the creation of an independent central bank, lack of a developed government bond market together with supply side shocks have resulted in volatile movements in price and an inflation rate that appears to be accelerating.
11. While the traditional family unit and the community have remained the core of Iraqi society, ensuring solidarity and social cohesion, conflict and inequality have eroded the social fabric of communities and families over the past three decades.
12. Historically, Iraqi social capital in the form of family and tribal networks had acted as a safety net against adverse shocks. Much of this capital has been destroyed through violence, dislocation, and the collapse of supporting institutions.
13. Civic participation and recognition of human rights were denied during the previous regime. They remain poorly understood and lack ancillary support structures.

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14. A large informal economy coexists with the formal sector. This informal economy may account for as much as 65% of Gross Domestic Product.²³ Even more worrisome is the large criminal element that controls large segments of the informal sector.²⁴

A recent UNDP²⁵ household survey documents the impact these factors are having on the average Iraqi household:

1. The UNDP survey suggests the poorest 20% of the population earns 7% of the income, while the top 20% earns 44%.
2. Iraq's median household income of 144 dollars has dropped from a post-war high of 255 dollars in 2003.
3. One-third of Iraqis canvassed by UNDP described themselves as being among the poor.
4. One-sixth of interviewees met all or most of the criteria suggesting that they lived beneath the poverty line.

Patterns of Success and Failure

As the discussion above suggests, reconstruction efforts to date have been characterized by some successes, but unfortunately a greater number of failures. Following Henderson²⁶, several patterns emerge. Most importantly, the Coalition's success stores shared some essential elements. Its less successful ventures had their own set of distinctive characteristics. Specifically, successful initiatives appear to have imposed no major costs or sacrifices on the population at large. For instance, most Iraqis welcomed the rehabilitation of their schools and hospitals. Also, successful initiatives did not suffer from security disruptions. This was either because the security situation was not a constraining factor—as with creation of new banking regulations—or because effective steps were taken to provide security protection—as with the nationwide distribution of civil-service salaries.

High visibility was another condition for success. Projects prioritized by Washington or the Coalition leadership, such as the introduction of a new Iraqi currency, were lavished with support. Funding was also a key element. Projects

²³ Robert Looney, "The Economics of Coping: The Plight of Women in Iraq's Informal Economy," *Journal of Social, Political and Economic Studies* 30:3 (Fall 2005), pp. 285-303.

²⁴ Robert Looney, "The Business of Insurgency: The Expansion of Iraq's Shadow Economy," *The National Interest* 81 (Fall 2005), pp. 67-72.

²⁵ United Nations Development Program, *Iraq Living Conditions Survey 2004, Volume I: Tabulation Report* (Baghdad: Central Organization for Statistics and Information Technology, Ministry of Planning and Development Cooperation, 2005)

²⁶ *Op. cit.*, pp. 4-5.

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that could be funded quickly, without going through cumbersome contracting channels achieved rapid results. For instance, the military's highly successful (but under-funded) CERP (Commander's Emergency Response Program) funds were used to respond immediately to pressing community needs. Programs that built on existing Iraqi capacity were also more likely to succeed. The child vaccination program which took advantage of a strong Iraqi outreach capability is a case in point. Finally, successful policies tended to be finite in scope and limited in duration – involving, for example the approval of a new law or the one-time distribution of textbooks to schools.

The Coalition's failures were marked by a very different set of conditions. Failure often coincided with high social cost. For instance, the coalition's inability to end fuel price subsidies reflected its fears of sparking mass unrest. Also most failed initiatives were afflicted by security disruptions, such as looting and sabotage that precluded sustained progress. Lack of powerful patrons was another handicap typical of unsuccessful projects. For instance plans for agricultural reconstruction languished with a committed CPA sponsor. Funding problems also characterized failed projects. Many projects ran into disabling delays when they encountered the complex U.S. government procurement process.

Another common element of policy failure was lack of existing Iraqi capacity on which to build. Efforts to collect taxes for example failed because did not have a history of voluntary compliance or the organizational capacity to monitor incomes. Finally, unsuccessful policies tended to involve extensive structural changes. The Coalition's inability to combat endemic corruption illustrates the difficulties in altering long-standing practices and relationships.

Perhaps because reconstruction efforts to date did not effectively incorporate large segments of the Iraqi population into the decision making process there is a wide spread perception among Iraqis that the coalition efforts have been a failure. One ABC survey of Iraqis interviewed in late 2005 found that:²⁷

Only 44 percent of Iraqis say they believe things are going well in their country; 52 percent said they felt the country was "doing badly." Support for the U.S.-led invasion has dropped: In February 2004, 39 percent of Iraqis told us they believed the invasion was wrong, but today that number stands at 50 percent. Even among optimistic Iraqis it appears the U.S. gets little credit for any improvements in their lives. Fewer than one in five Iraqis believes that U.S. reconstruction efforts have been "effective." Most Iraqis now say they "disapprove strongly" of how the

²⁷ "Fourth Installment of Where Things Stand in Iraq" ABC News, December 12, 2005
<http://abcnews.go.com/International/print?id=1378209>

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U.S. has operated in Iraq. Not surprisingly, the percentage of Iraqis today who oppose the U.S. presence has spiked -- from 51 percent to 65 percent.

Virtually all signs of optimism vanish when one is interviewing Iraq's Sunni Muslims. There's more on this in the Local Government section of the report; suffice for now to cite a pair of poll results. While 54 percent of Shia Muslims believe the country is in better shape than it was before the war, only 7 percent of Sunnis believe the same. Optimism about security -- 80 percent of Shias and 94 percent of Kurds say they feel safer -- is absent among Sunnis. Only 11 percent of Iraq's Sunni Muslims say they feel safer than they did under Saddam.

Many Iraqis cannot understand why -- two-and-a-half years after the Americans arrived -- electricity and sewage are not more reliable, why more reconstruction projects have not reached their neighborhoods, why corruption remains so prevalent and why their local (and in many cases democratically elected) officials have not changed things for the better.

These survey results were not unique. Another respected poll undertaken in the first week of January 2006 found a sharp split between Kurds, Shi'ites and Sunnis over the U.S. aid efforts in Iraq. Over the various categories of U.S. efforts, 38% of the Kurds expressed approval, falling to 30.3% for Shi'ites and 4.7% for Sunnis. The corresponding figures for disapproval were 11.3%, 14.8% and 77.7%

Lessons Learned

The post war Iraqi reconstruction experience points to some important lessons. These can provide a useful set of guides for the Marines' attempts in restoring economic growth and stability.²⁸

Reconstruction entails painful trade-offs rather than easy choices.

Perhaps the major made in the early days of reconstruction was a tendency to try to get things done as quickly as possible. To do this the CPA often bypassed Iraqi Ministries and various local groups. More often than not, Iraqis and their viewpoints were not included in the process. This flaw continues to take a toll on the country's reconstruction efforts.

High hopes and lofty promises are no substitute for sound planning and prudent expectations. As we receive clearer accounts of the functioning of the CPA it is shocking to find how little planning went into the effort.

²⁸ Anne Ellen Henderson, The Coalition Provisional Authority's Experience with Economic Reconstruction in Iraq (Washington: United States Institute for Peace, April 2005), pp. 5-16.

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Control expectations to realistic levels. Because the CPA had promised to quickly exceed rather than simply restore prewar production its many accomplishments were often seen by the Iraqis as failures instead.

For any actions develop several contingency plans. Proper contingency planning taking into account the possibility of infrastructure degradation, persistent violence and revenue shortfalls would have resulted in more realistic reconstruction goals.

Economic reconstruction depends upon adequate security; yet security depends on successful reconstruction. While the CPA was quite aware of the needs for security, it did not appear to realize that its reconstruction efforts reconstruction should be focused not on just constructing physical buildings such as schools, but instead primarily on creating an environment in which the average Iraqi would feel secure. Delays should have been avoided if at all possible. Instead the many of the CPA's self-inflicted delays in project implementation contributed to Iraqi feelings of resentment and despair, which, in turn, fueled insurgency and crime thereby worsening the security climate.

Reconstruction requires coordination of short-term initiatives and long-term structural reforms. The coalition's short-term successes in economic stabilization and small-scale reconstruction generated positive momentum for economic recovery. Yet the CPA's inability to carry through with longer-term programs such as restoring state-owned enterprises, creating sustainable jobs, and promoting private sector growth resulted in lost momentum and further Iraqi frustration.

Don't Over-Rely on Market Forces in a Conflict Setting. In part, the loss in reconstruction momentum stemmed from the CPA's assumption that market forces and a surge in private investment would follow the initial reconstruction efforts. Ideological blinders²⁹ and the lack of a contingency plan made it difficult to overcome these errors when confronted with the effects of increased violence and uncertainty.

Ongoing reforms require empowered owners. It remains to be seen whether Iraq's new government will be willing or able to continue economic reforms initiated under the CPA. Clearly if Iraqis had been consulted and made an integral part of the reform process they would be more inclined to continue and build on earlier efforts. As of early 2006, the reform process is being largely controlled by the International Monetary Fund, with Iraqis again more in the position of resisting outside efforts at reform, largely removal of subsidies

²⁹ Robert Looney, "The Viability of Iraq's Shock Therapy," Challenge 47:5 (September-October 2004), pp. 86-103.

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and price controls, rather than controlling and adapting the reform process to meet their own domestic priorities.³⁰

Broad-based participation is critical for maintaining reform momentum, but requires overcoming centralization tendencies. Creating Iraqi ownership of reconstruction also required decentralization of government authority. Decentralization has been shown to strengthen accountability and stimulate economic recovery in other post conflict and transitional settings. Unfortunately the CPA was successful in overcoming Ministry opposition securing funding for local authorities and Iraqi citizens to participate directly in the reconstruction process.

Overcoming and controlling corruption is extremely difficult. Corruption thrives in the environment of post-conflict reconstruction. The combination of large public procurement projects, minor funding infusions, and inadequate government regulatory mechanisms creates fertile ground for corrupt practices. In the Iraqi context, a long history of entrenched corruption in government economic management only compounded the problem.

Considerations for Future Efforts

Anthony Cordesman's blunt assessment of the problems the U.S. encountered in reconstructing the economy provides another insight as to the changes that will have to take place if economic progress is to occur if economic growth is to be revived anytime soon. In large part, earlier efforts failed because they were not capable of adjusting to the growing insurgency and criminal threats. On the other hand the top-down approach would have most likely encountered numerous constraints. As Cordesman notes:³¹

1. The U.S. government simply lacks the core competence, personnel and financial resources to take on such a massive undertaking as the reconstruction of a failed economy of 25 plus million people. "The illusion that the US can remake a national economy, as distinguished from aiding a nation to do so is simply dangerous. So is the idea that the US has or ever will have the cadre of experts necessary to carry out such tasks at the career civilian, contract, and military level. The CPA, USAID and the Corps of Engineers simply showed again and again that the US could not provide workable plans and program management for an aid effort of the scale involved, and that reliance on US prime contractors and their subcontractors did nothing to reduce waste and corruption."

³⁰ Robert Looney, "The IMF's Return to Iraq," Challenge 49:3 (May/June 2006), pp 68-82.

³¹ Anthony Cordesman, "The Importance of building Local Capabilities: Lessons from the Counterinsurgency in Iraq," Draft, CSIS August 1, 2006, pp. 20-21.

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2. In a conflict setting such as Iraq's, the first priority is to use aid money as a tool to bring about stability and one that responds to operational needs. "There simply is no time to wait for structural change in the economy, for mid-to long-term projects to pay to pay off, for interesting experiments to work, by acting as if war, insurgency, crime and social violence can be ignored. Iraq and Afghanistan have also shown that US military officers and their US government civilian counterparts must have great discretion in using aid at the local level and essentially substitute dollars for bullets. Buying stability is cheaper by far than shooting for stability and much less provocative and destructive. It also provides quick benefits in terms of results the local populace wants and sees, disperses aid into the most troubled areas, and builds political trust."

Unfortunately at the present time and for the foreseeable future, circumstances in Iraq largely preclude activity by agencies that would normally, fund, organize and administer aid efforts. "...it is clear that NGOs and international institutions are often unsuitable for such activities. They cannot protect themselves and often will not allow the US military to do so. They bring their own institutional agendas and priorities into the field and will not act in concert to achieve the kinds of operational results needed for security operations or to buy political support and consensus. There are often times where this independence frees the US of political pressure, but stability operations and nation building needed to use short term aid for just the opposite purpose."

3. The current security situation together with shrinking budgets for reconstruction mean that the U.S. aid strategy in Iraq will have to reorient itself from a top down approach to that of a grass-roots, bottom-up strategy. "A reliance on local governments, businessmen, entrepreneurs and contractors at least keeps aid money in the country it is intended to benefit, shows the local populace that the US is directly aiding them, and responds to local needs and priorities."

Cordesman's three insightful observations point to the general direction a successful reconstruction effort must follow. Clearly Coalition economic efforts will have to take on the dual role of reconstruction and counterinsurgency. The specific form that effort takes will be conditioned by a number of interrelated factors including: (a) the growth and dynamics of the shadow or informal economy, (b) the deterioration in social capital, and (c) the evolving relationship between tribes, gangs and the insurgency as conditioned by the dynamic interactions with (a) and (b).

The Shadow Economy

When coalition officials arrived in Iraq after the war, they planned on turning Iraq into a free market economy – a model for capitalism in the Middle

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East.³² As part of this plan, they expected private companies, both foreign and domestic, to play a leading role in jump-starting the economy. Free market incentives driven by pent-up demand and a massive aid-financed reconstruction program were thought to be sufficient to induce a massive wave of investment and hiring of Iraqi workers.³³ But violence, crime and uncertainty over the future have undermined investor confidence, preventing market-driven mechanisms from playing their anticipated role. As a result nominal GDP contracted by about 35% in 2003. It has recovered little since then, despite the U.S.-led reconstruction efforts.

The only part of the economy to have survived both Saddam Hussein and the post-2003 period of instability and insurgency is the country's informal economy. In fact, there is ample evidence that the country's informal economy has expanded considerably since Saddam's overthrow. In this regard, Iraq's informal economy is following a pattern seen in other parts of the world – the informal economy tends to grow during periods of political, economic, and social crisis.

Despite the obvious importance of the informal economy, it is barely mentioned in the many official economic reports. In fact, few systematic attempts have been made to integrate the analysis and quantification of the informal economy into an overall review of economic and military developments in Iraq. This gap in our knowledge has hindered the development of a systematic framework for understanding and planning reconstruction and counterinsurgency strategies in the contemporary Iraqi setting.

Preliminary analysis³⁴ suggests, a clear pattern exists whereby the relative size of a country's informal economy (as a share of Gross National Product) is related to its progress in opening up to the world economy. Those countries that are relatively closed and inward oriented (like Iraq around the year 2000) tend to have large informal economies, while those countries open to the pressures of globalization have much smaller informal economies. Furthermore, the informal sector becomes significantly smaller as countries increase their control over corruption.

As might have been expected, Iraq under Saddam was in a group of countries with the highest probability of possessing a large informal economy.

³² Cf. Robert Looney, "Iraq's Economic Transition: The Neoliberal Model and Its Role," *The Middle East Journal* 57:4 (Autumn 2003), pp.568-587.

³³ Ariana Eunjung Cha, "New U.S. Weapon: Jobs for Iraqi Men," *Washington Post*, February 22, 2004 p. A. 18.

³⁴ Cf. Robert Looney, "Iraq's Shadow Economy," *Rivista Internazionale di Scienze Economiche e Commerciali* (forthcoming, 2005).

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The profile of these countries is an inward-oriented trade regime with high levels of corruption. On this basis, Iraq's shadow or informal economy probably accounted for around 35% of Gross Domestic Product (GDP) in 2000³⁵ with nearly 70 percent of the labor force employed in informal activities.

Since the fall of Saddam, Iraq's informal economy has been affected by that country's on-going crisis. Clearly conflict and the insurgency have taken a heavy toll on the formal economy. As private firms or public enterprises are downsized or closed due to conflict, retrenched workers often find the informal sector the only source of livelihood. Also, in response to conflict driven inflation or cutbacks in public services, households have often needed to supplement formal sector incomes with informal earnings. In some parts of the country such as al Anbar, the breakdown of law and order has led to an expansion of criminal activity, some of which is carried out in the shadow economy – street vendors selling stolen merchandise etc.

A partial list of factors contributing to the current expansion of Iraq's shadow economy includes:

- Compared with the previous regime, there is considerable political liberalization in Iraq. In transition economies, this normally results in a larger informal economy.
- The demand for services and trade is particularly high due the introduction of free trade soon after the fall of the Hussein regime. Again, this factor would encourage the development of an informal economy—petty retailing, street vending of imported goods, etc.
- Increased bureaucratic discretion and associated corruption are greatly contributing to the informal economy.
- Because of Iraq's insurgency, institutional enforcements have weakened, thus allowing the incentives for informal activity to become very high.
- The underdevelopment in the rule of law and related institutional enforcement mechanisms have not improved to date. Given the insurgency, the enforcement mechanisms may have even declined.
- In Iraq's case, the present extremely low tax structures should not have been a contributing factor to the informal economy, but many marginal firms do not like to pay any taxes.

³⁵ Ibid..

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- The macroeconomy has been relatively stable, but rising inflation in some areas may be contributing to an expansion of the informal economy.

Of the items noted above, the most critical factor affecting the size of the informal economy is no doubt the inability of the Iraqi government to control corruption. In addition, given the insurgency and uncertainty surrounding political developments, it is safe to say that large segments of the population have reverted to the survival relationships characteristic of the period of sanctions in the 1990s. This is confirmed daily with the news coming out of Iraq describing economic mismanagement,³⁶ vast black markets in gasoline³⁷, increased crime, and shortages of critical inputs.³⁸ These developments do not bode well and suggests that the current size of the informal economy is considerably larger than in the late 1990s. As noted above, another ominous sign³⁹ is a recently released index of corruption for 2004. The prestigious Transparency International Corporation ranks Iraq as the most corrupt country in the Middle East. In 2004 the country's ranking was 129th out of 145 nations worldwide. By 2005 it had fallen to 135 out of 158 countries.⁴⁰

Based on these factors, it is likely that the size of the underground economy has expanded significantly beyond the 35% of GNP figure, noted above, for the end of the Hussein regime. A safe estimate, in light of the insurgency and its detrimental impact on investment, electricity, and transport, would put the informal economy at around 65% of Gross National Product. This figure is reinforced by the unemployment stemming from the disbanding of the army and the anti-Baathist campaign following Saddam's overthrow.

In addition to the factors noted above, the informal economy may be growing simply because of the constraints limiting expansion of formal economic activity. Just as private capital formation is often critical to the development of a thriving modern economy, social capital creation may be just as essential in creating the shift to more formal activities. Again, corruption plays a significant role in structuring the informal – this time through its effect on the country's social capital. Figure 2 provides a summary of the factors impacting on the country's informal/shadow economy.

³⁶ Sabri Zire Al-Saadi, "Iraq's Post-War Economy: A Critical Review," Middle East Economic Survey XLVII:14 (April 5, 2004).

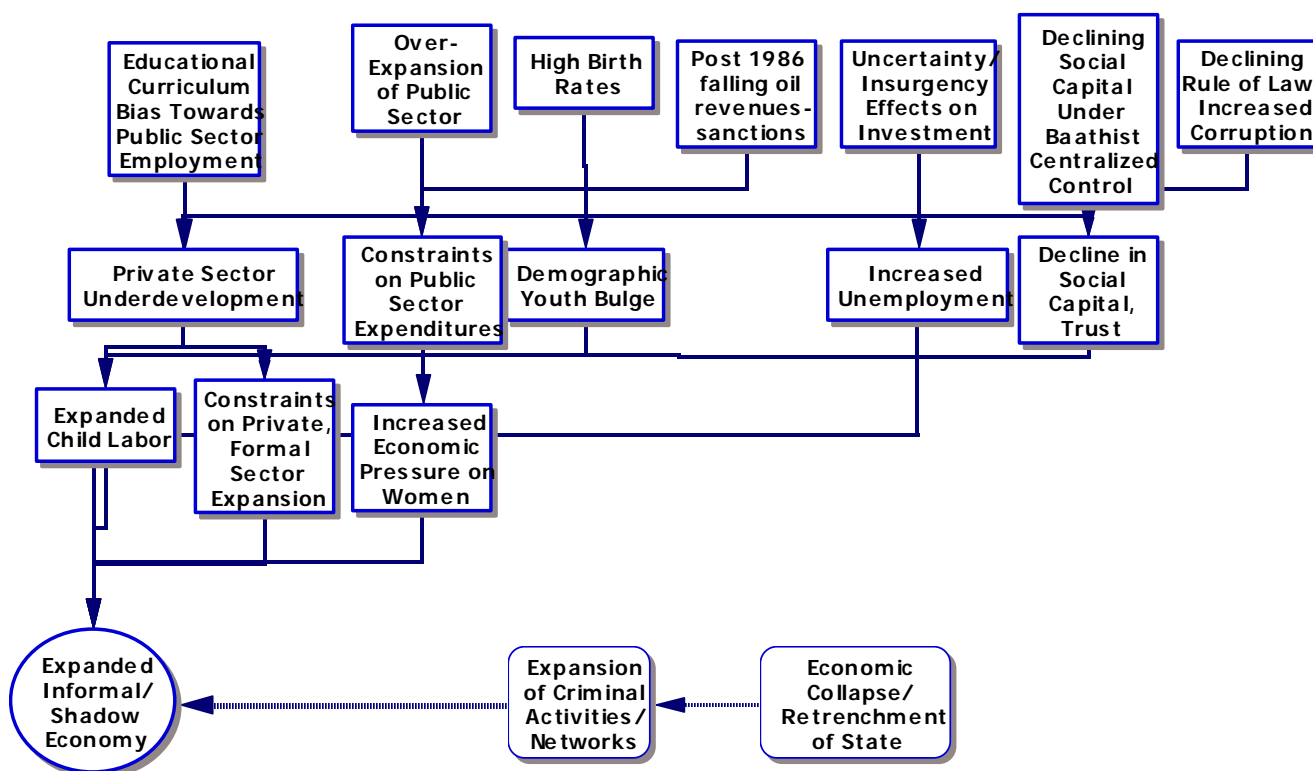
³⁷ "Iraq: Report of Continuing Fuel and Electricity Shortages," Nooz.com (January 23, 2005).

³⁸ Dan Murphy, "In Iraq, a Winter of Discontent," Christian Science Monitor, January 10, 2005.

³⁹ Also see Adam Davidson, "Still on the Take: The U.S. Has Not Ended Iraq's Culture of Corruption," Los Angeles Times, May 2, 2004, p. M.1.

⁴⁰ http://www.transparency.org/policy_research/surveys_indices/cpi/2005

Figure 2
Dynamics of Iraq's Informal Economy



The Deterioration in Social Capital

Social capital refers to networks of relationships that bind people together.⁴¹ Social capitalists distinguish such relationships from physical capital and, the attributes of individuals, or human capital⁴². In the context of Iraqi reconstruction and the establishment of a market economy, a key element of social capital centers on a component of social capital, the notion of trust.

A growing literature⁴³ on social capital stresses the importance of trust in the institutional infrastructure of a market economy. The focus on trust is inspired by its importance for business formation, which in turn seems to be crucial for explaining the variation in economic performance in a large cross-

⁴¹ An overview of the literature on social capital can be found in Martin Paldam, "Social Capital: One or Many? Definition and Measurement," *Journal of Economic Surveys* 14:5 (December 2000), pp. 629-654.

⁴² Christopher Scanlon, "The Problems With Social Capital," *The Age* (July 19, 2003).

⁴³ The following draws on Robert Looney, "Economic Consequences of Conflict: The Rise of Iraq's Informal Economy," *Journal of Economic Issues*, XL:4 (December 2006).

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section of developing and transition economies. Entrepreneurship cannot flourish in an environment of distrust, since many economic opportunities are closed off. As Nobel laureate, Kenneth Arrow, has noted:

Almost every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of economic backwardness in the world can be explained by the lack of mutual confidence.⁴⁴

The transition to a market economy experience of many of the former Communist countries suggests successful modernization and development take place through a web of diversified social life, mediated by families and communities, and the personal relationships of people within them.⁴⁵ In a similar fashion, Fukuyama⁴⁶ has identified trust as a central value in prosperous, highly productive societies. Trust is a cornerstone of individuals' ability to subordinate their own interests to those of larger groups and to associate and cooperate with each other to achieve economic purposes and other social satisfactions.

Trust is such a critical factor in the development of modern economies because it motivates contacts with others and opens access for the exchange of goods and services. It facilitates cooperation and cooperation in turn, breeds trust in a two way interaction necessary for the creation of long-term generalized norms for cooperation. Social capital thus represents a set of resources rooted in networks of relationships possessing the power to facilitate economic progress. There are three types of relationships among parties to an economic transaction, giving rise three different types of trust:⁴⁷

1. Ascribed Trust. This first type of relationship is found among kinship groups and family members. These relationships dominate economic transactions in subsistence economies and still characterize reproduction and the household economy (but also many small-scale crafts and trades).
2. Process Based Trust. This type of relationship is between individuals that have known each other for a long time, without sharing the loyalty to a specific group. Most business networks are characterized

⁴⁴ Kenneth Arrow, *Altruism, Morality and Economic Theory* (New York: Russel Sage Foundation, 1975).

⁴⁵ B. Berger, *The Culture of Entrepreneurship* (San Francisco: ICS Press, 1991).

⁴⁶ Francis Fukuyama, *Trust: Social Virtues and the Creation of Prosperity* (New York: Free Press, 1995).

⁴⁷ Martin Raiser, "Trust in transition" <http://www.colmud.hu/honesty-trist>

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by this type of repeated relationship and the prevalence of what develops as a process-based trust.

3. Extended Trust. This relationship is between individuals, who enter into a transaction with only limited information about the counterpart's specific attributes. For economic exchange to take place between these types of individuals, generalized or extended trust is needed. The importance of this third type of relationship and the correspondent economic transactions between largely anonymous individuals is a key element of a modern economic system.

This topology suggests that the building of extended trust is a key challenge in Iraq's development to a modern economy. It is also important to bear in mind the relationships between the various forms of trust. In particular, extended trust could not exist without the experience of reciprocity made in repeated interactions among family and other members of a societal or business community. Where process based trust is absent, extended trust is unlikely to develop.

Moreover, it is unlikely that extended trust in economic exchange could be sustained without the availability of third party enforcement by the state. Clearly, trust in government institutions will be a necessary prerequisite before Iraq can expect any type of significant expansion of the formal economy. Here is where the country's problems lie. One of the main impediments to a formal market in Iraq today is the absence of trust at most levels. The Ba'athist government created a profound imprint on the nature of formal and informal institutions in Iraq. Not only did, Ba'athism hamper the emergence of a market economy, it corrupted the judicial and legal institutions needed to create and nurture trust.

In short Iraqi values today are no longer those that were reported in earlier accounts of the pre-Ba'athist period, which stressed the country's vibrant entrepreneurial spirit. Individual and managers' values have been affected by years of repression under authoritarian top-down decision making. In an environment of several decades of political and economic insecurity, doubt and distrust are deeply entrenched in the individual mind. They represent a major constraint against drawing entrepreneurs and individuals out of the safe, kinship-based informal economy.

One of the main criticisms of U.S. policy in post-war Iraq has been its rejection, not only of social reform, but of the very state-centered approaches that were critical to the reconstruction and subsequent economic growth in post-war Japan and Germany. At the same time, fundamental social reforms

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were ruled out.⁴⁸ As might be expected, combined with the demise of the state as a safety net, the lack of trust in the buying and selling of goods and services has resulted in the contemporary Iraqi economy being divided into segments of largely non-overlapping networks.

Ascribed Trust Networks

First and by far the largest in number in Iraq are the individual and business networks built on ascribed trust. These are usually confined to the local, informal economy. Most ascribed trust networks involve groups bound together by family, tribal, or ethnicity, which facilitates business organization built on oral contracts. Many of these networks have the potential to expand through selective interaction with outsiders. However, such expansion will take time in Iraq, especially under the current conditions of public corruption and great uncertainty over the enforceability of contracts.

In today's Iraq, many ascribed trust activities fall in what is commonly referred to as the coping economy -- numerous economic interactions during armed conflict that provide benefits to the civilian population, particularly the poorest and most vulnerable. These functions are even more important to civilian livelihoods where the formal economy and traditional livelihoods are destroyed or rendered difficult or impossible to sustain. The coping economy includes a wide range of activities including subsistence agriculture, petty trade, and various out of the household businesses – catering, food processing, and the like.

Of the country's three main economic sectors, it is reasonable to assume that the coping economy contains a disproportionate share of the country's poverty. Recent data released by the Ministry of Labor and Social Affairs indicate that about 5 million Iraqis are living under the poverty line, compared with 143,000 in 1993⁴⁹. Significantly, the Ministry noted that more than one million Iraqi women aged 25 to 40 were unmarried, while divorce cases were increasing as was child labor. It is reasonable to assume that this group of women is firmly entrenched in the coping economy.

Process-Based Trust Networks

Second, there are the process-based trust networks reliant on existing ties between the previous members of the Ba'ath government and criminal groups – smugglers, etc. — that thrived during the sanctions period of the 1990s. Today, these activities are largely in the criminal area. The emergence

⁴⁸ Mark Selden, "We Aren't Close to Doing What We Did in Japan," <http://hnn.us/articles/5873.html>

⁴⁹ "Five Million Iraqis Live Under Poverty Line: Report," Xinhua News Agency (February 12, 2004)

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of pervasive criminality was readily apparent soon after the overthrow of Saddam Hussein.

If anything, these problems have become increasingly severe. According to a U.N. report, “The emerging crime problem is subtler and scarier: theft, extortion, and drug- and arms-smuggling operations that have become more sophisticated, more clandestine, and more organized. In Baghdad, one team of thieves recently burned down a warehouse filled with the hot booty of another group. It was one mob sending a message to another⁵⁰”.

As in the case of the ascribed trust groups, the activities of these networks have been affected by the insurgency. However, process-based networks' activities often directly contribute to prolonging the insurgency through:

- The destruction or circumvention of the formal economy and the growth of informal and black markets, effectively blurring the lines between the formal, informal, and criminal sectors and activities;
- Pillage, predation, extortion, and deliberate violence against civilians, used by extort ransoms, capture trade networks and diaspora remittances, and exploit labor;
- High decentralization, both in the means of coercion and in the means of production and exchange;
- The use of licit or illicit exploitation of trade in lucrative natural resources;
- The reliance on cross border trading networks, regional kin and ethnic groups, arms traffickers, and mercenaries, as well as legally operating commercial entities, each of which may have a vested interest in the continuation of conflict and instability.

Scores of the cross-border relationships cultivated by the various smuggler/criminal groups in the 1990s are still in place and operational at the present time. Goodhand observes that the shadow economy is frequently already widespread before the outbreak of conflict and is a permissive factor for conflict when it contributes to violent state collapse. Or it serves as a source of income to would-be-rebels. Once conflict erupts, shadow economies are easily captured by combatants and thus often become the basis for the combat economy⁵¹. This has happened in Iraq, with the current wave of

⁵⁰ Mark Fritz, “Arms and Drug Smuggling Rise as Crime Gets Organized in the New Iraq,” Associated Press, July 5, 2003.

⁵¹ Goodhand, op. cit.

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kidnappings and smuggling providing significant financial assistance to the insurgency⁵².

Western intelligence agencies are becoming increasingly worried this systematic strengthening of ties between terrorists and organized crime. Stefan Maier of the German Institute for International and Security Affairs confirmed that cooperation between the two camps was on the rise, despite their different political and economic motives⁵³. As he observes: "Common ground between terrorists and organized criminal groups can be found primarily in two areas. First, the two come together in money-laundering activities: Terrorists often need to park their money temporarily with somebody else to cover up their tracks. Secondly, they need weapons, and they usually get them straight from organized crime⁵⁴."

"With the lack of security measures, disorganized crime became organized crime," said Hania Mufti, Baghdad director of Human Rights Watch. "Then, at some point, there was a merging between organized crime and political crime."

In today's Iraq, terrorist groups use many of the same channels for their activities that the Iraqi government and associated criminal groups used in the 1980s and 1990s. In this regard, Iraq is an ideal environment. Decades of socialist and statist experiments of the Ba'ath Party regime, together with subsequent wars and the consequences of UN sanctions, left the Iraqi economy heavily damaged, distorted, and exposed to administrative and political interference⁵⁵. Within this context, terrorists, insurgents, and organized crime elements have been able to thrive through exploiting various economic and institutional weaknesses.

Extended Trust Networks

While extended trust networks may involve some reliance on kinship and family relationships, they are largely characterized by transactions between largely anonymous individuals. As noted, they are a key element in a modern economic system. Since the focus of the present analysis is on the informal economy, these networks will not be treated in detail other than to note that they are largely undeveloped outside the public sector and the national oil industry. Some banking arrangements are moving in this direction, albeit extremely slowly.⁵⁶

⁵² Roshan Muhammed Salih, "Crime and Disorder Thriving in Baghdad," Aljazeera.net (April 3, 2004).

⁵³ <http://www.dw-world.de/dw/article/0,1564,1352140,00.html>

⁵⁴ Ibid.

⁵⁵ Robert Looney, "A Return to Ba'thist Economics," *Orient* 45:3 (2004), pp. 385-400.

⁵⁶ Cf. Robert Looney, "Postwar Iraq's Financial System," *Middle East Policy*, XII:1, Spring 2005.

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Social capital and its implications for informal activity are summarized in Table 5. Clearly, for Iraq, the key challenge facing the economy is developing the conditions conducive to the creation and growth of extended trust networks to encourage the growth and development of this type of networking. Conversely, the lack of supporting institutions has constrained most economic agents and those entering the labor market to informal activities characterized by family/kinship based ascribed trust.

Adding network and labor market conditions to the equation provides additional insights to the factors shaping the overall size and, to some extent, the composition of Iraq's contemporary informal economy. These are summarized in Figure 1, with the informal economy seen largely a function of fundamental supply and demand factors: (a) a youth population bulge, (b) a long-standing state employment program providing incentives for employment in the public, but not private sector, (c) a workforce of diminished skills following a long period of sanctions, (d) little private sector growth stemming from the instability and the insurgency following the overthrow of Saddam Hussein (e) deficient social capital, especially in the form of trust, thus confining most private sector transactions to the informal market, and (f) openness to trade (neo-liberal reforms) makes many potentially profitable firms unprofitable. In turn, the lack of a sizable private sector reduces the links often found between the informal and formal economy.

Because the informal economy is largely the result of a convergence of powerful long-run demographic and economic forces, it will be a fixture for some time to come. At best, informal activities may evolve over the next several years with some progression from ascribed based networks to process based networks. If this transition is viewed as successful by Iraqi entrepreneurs and the government makes significant strides in the governance area, then the progression to process based networks and extended modern networks is a distinct possibility, particularly if the security situation stabilizes enough to support foreign direct investment.

However, a good case can be made that under current conditions, the development and evolution of organized networks may perpetuate and even expand the informal/shadow economies. Many of the organized networks today have evolved out of Ba'th party efforts to limit traditional centers of tribal authority. In effect the Ba'th party encouraged the growth and proliferation of informal associational links locally.

Evolution of Local Networks⁵⁷

More precisely, local-level kinship affiliation was increasingly encouraged as the effects of the 1980s war with Iran and the sanctions of the 1990s drained the power of the central government. Particularly after the 2001 Gulf War, the central government was weakened to the extent that it was unable to perform many of its traditional military, economic and security functions.⁵⁸

The Ba'thist survival strategy during this period was for the party to serve as a broad tribal unit local associations performing in supporting roles. By 1996 officially sanctioned "tribes" were responsible not only for the maintenance of law and order locally, but also collected taxes on behalf of the government, were appointed judicial powers and extended tribal customary law to the extent of their territorial reach. They received arms and ammunition, vehicles, and logistical support as payment for services rendered to the party.

Local dominance of revived tribal networks was evident in the 1998 crisis involving the United States. At that time, heavily armed and equipped Sunni tribal units were positioned in and around Baghdad to control the restive urban population, a role formerly belonging to the Ba'th party militia. With time the interests of the central government and local networks began to diverge. Clan based groups controlled the highways around Baghdad. They increasingly turned to criminal activities -- looting, smuggling, and hijacking throughout most of al Anbar province. Conditions deteriorated to the extent that convoys were necessary even for basic travel in daylight to avoid raids by tribal guerillas.

By 2000, policeman, judges, and party officials were subject to violent tribal recriminations. Encounters between Iraqi soldiers and tribal irregulars, especially those based in al Anbar province escalated in terms of frequency and scale. In this ever more lawless environment, tribal elements began to take over many of the local, informal street-markets. These markets comprised a sub-stratum of the informal Iraqi economy that, as noted above, began to grow in the early 1980s as a result of chronic resource scarcities brought on by war, unrest, and a decade of sanctions.

In addition, Saddam Hussein's selective distribution of increasingly scarce resources created some of the underlying group rivalries that exist today. By directing funds, rations, government positions, electricity, clean water, fuel and industrial investment toward specific villages in the western Sunni regions in

⁵⁷ This section draws heavily on Nicholas I. Haussler, Third Generation Gangs Revisited: the Iraq Insurgency, Masters Thesis, Naval Postgraduate School, September 2005, pp. 33-41.

⁵⁸ Excellent accounts of this period is given in: Joseph Braude, The New Iraq (New York: Basic Books, 2003), and Stephen Glain, Mullahs, Merchants, and Militants: The Economic Collapse of the Arab World (New York: St. Martin's Press, 2004), ch. 5.

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exchange for service to the regime, and withholding resources to other villages as a punitive mechanism, a local-level competitive calculus developed that was perpetuated by Hussein as an instrument for rule. Because the state-level formal economy was dramatically curtailed by sanctions, this competition for resources further encouraged the growth of informal activities and employment.

The tendency of corrupt party and state institutions to favor key supporters and engage in fraud in the distribution of goods and services encouraged those operating in the informal (and formal) economy to rely on local level mediation by tribal groups. Because informal activity is based in large part on social capital -- the trusted familial and kinship ties noted above, local tribal groups played a central role in the expansion of the informal economy. By assessing fees for the settlement of disputes and collecting taxes on local production, local tribal groups also began to establish financial support free of state control.

Tribal groups were also increasingly involved in criminal-type activities, especially in the western border regions. Illicit criminal networks were initially based on the cross-border smuggling of animals, tea, alcohol, and electronics. Later these activities began encompassing the drug trade. Tribal based organized criminal activities increased toward the end of Ba'athist rule with many party members becoming involved due to declining opportunities to acquire official resources. By early 2002, the entire route along the Euphrates River in Al Anbar had essentially developed into a sanctuary for illicit traffickers and criminal entrepreneurs.

Resource scarcity and the stature of sub-tribal groups were both greatly enhanced at the local level following the removal of Saddam Hussein:

- The Coalition Provisional Authority's CPA early adoption of a neo-liberal economic program impeded the growth of regulatory and legal institutions. This institutional vacuum forced businesses and those entering the labor market to rely on the trusted kinship or extended family networks of the informal economy.
- Shortages of critical inputs such as electricity and fuel, and the dangers of transportation further encouraged informal entrepreneurs to rely on tribal and extended family associations for protection and support.
- As noted above, endemic corruption and uncertainty have contributed to a dramatic increase in the informal sector following the 2003 invasion. As a result approximately eighty percent of the

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labor force is now engaged informally, accounting for nearly two thirds of Iraq's gross domestic product.

- Growth of the informal economy is particularly evident in certain areas west of the capital, where the destruction of the Sunni-oriented military establishment and related industries has contributed to a substantial contraction of formal activities and jobs.
- A principle driver of this growth has been a dramatic rise in criminal activity related to the shadow economy and dominated by local-level tribal elements, including the emerging economies based on the distribution of scarce resources, kidnapping, trafficking in petrol, narcotics, looted weaponry, and the targeting of coalition forces.
- In areas beyond the control of the Iraqi government and lacking a substantial coalition presence, the shadow economy is rapidly displacing any legal or semi-legal structures that may have survived until the present.

The removal of the Hussein regime and the actions of the CPA presented a range of opportunities and constraints that have in part determined the manner in which street-level groups have mobilized and generated new opportunities and constraints for both the original organizations and follow-on groups over time. This evolution has gone through three distinct phases: (1) March 2003-December 2003; (2) December 2003-January 2005; and (3) January 2005 to the present.

March 2003-December 2003

During this initial phase, the persistent lack of security and the policy directives issued by the CPA accounted for the greatest opportunities for armed groups to expand their positions locally. Within this period the most prominent actors at the street-level in terms of mobilization potential, organization and stature within the surrounding community were those legacy groups of local/kinship based "tribal" associations reminiscent of the period under sanctions.

These groups are composed of pre-existing social groups (some former regime elements, and perhaps regime opponents) within the tribe that come armed and equipped, and they are activated by conflict, inspired leadership and the prospect of loot.

A second tier of gangs was comprised of those groups engaged in entrepreneurial and organized criminal activities, also a legacy of the sanctions. These gangs are largely based on local associations. While there is some

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degree of overlap between these two tiers the fact that many tribal groups maintained militias precisely to protect their local economic interests from Ba'th encroachment prevented an alignment between these two groups -- at least in the immediate aftermath of the invasion.

The chaotic lawlessness of this period presented a significant opportunity for groups in both tiers to solidify and extend their presence locally. Hesitation on the part of coalition forces to manage the deteriorating security situation in most urban centers, particularly Baghdad, acted as a catalyst in the very process of institutional devolution that had been occurring under the Hussein regime. The vacuum that developed in the weeks following the invasion increased the scale and intensity of this process as the role of self-protecting mutual assurance groups responded to the precipitous decline in law and order.

In sum, CPA policies of "de-Bathification," disbanding of the Iraqi national army, and the Coalition's ambivalence toward the rise of militias presented a second opportunity for street level gangs to expand their influence and control of resources. By the closing months of 2003 the die had been cast.

December 2003-January 2005

Hostilities between coalition troops and local populations, the inability of coalition forces to adequately repress insurgent violence, and the return of sovereignty to the Iraqi government provided the most significant opportunities for the various local networks to expand during this second period.

First, the dominant groups at this stage reflected a three tiered structure. The networks corresponding to the two most prominent groups began exhibiting a high degree of overlap:

- The combination of tribally-based former security personnel and criminal groups comprised the first tier.
- The second and third tiers were occupied by indigenous elements motivated by vendetta, and extremist Islamic ideologies, respectively.
- Factors such as the collateral costs of the Fallujah operations and the abuse of detainees at Abu Ghraib, represented a substantial political opportunity by further legitimizing the existence of armed street-level groups.

This environment facilitated the emergence of the second and third tier of violent street level actors. These actors, predominantly foreign in the latter

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case, were easily absorbed by the expanding networks of street levels groups. These groups provided both the means and an added incentive to engage in anti-coalition targeting by offering generous monetary incentives.

This pattern of network evolution was further stimulated by shifting budgetary patterns after June 2004 – the time the CPA transferred control of government portfolios and the national budget to Iraqi ministries. This shift in budgetary authority represented a political opportunity for the street-level groups. Specifically, the allocation of state assets reflected a new budgetary dynamic that tended to favor those interests centered in Baghdad over the remote provincial areas. As a result, the capacity of the coalition to respond to conflict conditions and proceed with reconstruction was seriously weakened.

Second, newly appointed ministers fostered a climate of parochialism by attempting to establish an independent, self-supporting infrastructure within the new institutions under their control. The relationship between the Ministries of Interior and Defense is instructive. Both ministries assumed control of an array of smaller “special” units comprised of thousands of supporters and local affiliates, sustained by diverted funds intended for aid and reconstruction.

January 2005 to the Present

In addition to a continuation of many of the dynamics noted above, this period has been marked by a set of new opportunities created by elite cleavages within the National Assembly, the increased politicization of militias and the continued expansion of the shadow economy.

Changes in the street level dynamic have been consistent with the opportunities for expansion. Again a first-tier of networks exists, possessing a high degree of overlap between entrepreneurial and organized criminal networks. They are comprised largely of Iraqis harboring some form of vendetta or personal grievance against the coalition. A second tier of actors is comprised of foreign and domestic Islamic extremists.

As in the earlier two periods, demand for weapons, stolen goods, and hostages determine the roles and relationships between street-level actors more so than ideological or political convictions. Yet in this phase, engagement in the black market has not merely enabled sustained street-level activity, it has in many cases become the activity itself, dominating collective resources and driving group expansion in terms of capabilities and reach. The shift is evident in certain portions of al-Anbar province where despite frequency of anti-coalition targeting, criminal endeavors are now thought to account for the bulk of street-level activity. Clearly the draw of the shadow economy is a major factor tending to decrease the likelihood that Sunni groups will participate more in the political process in the near term.

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Summing up the evolution of local network development in Iraq, a pattern emerges whereby during each phase of the post war period the position of locally-oriented armed groups has been solidified and expanded in a manner consistent with the type and timing of the political opportunities available. The most significant opportunities have included:

- The slow recognition of security conditions facilitated the establishment of armed groups in the first phase. This first phase also represents the playing out of the structural conditions stemming from the sanctions regime.
- An appreciable shift in the street level dynamic in terms of the relative predominance of certain actors in the second and third phases. This transition has favored the position of indigenous groups radicalized through interaction with the coalition, with a higher degree of overlap between all groups and the shadow economy in the current phase.

State level political openings may lure some elements of resistance into the political process, but in the present phase, the draw of the shadow economy may be sufficiently strong to keep groups engaged in street-level violence.

Outlines of a Strategy to Combat Insurgent/Criminal Networks

Several years have passed since the removal of Saddam Hussein, yet there are few indications that the degree of Sunni-led violence will decline. On the contrary, violent activity has increased in frequency and scale over this period.

Mechanisms of Insurgent/Criminal Network Expansion

The evolution of local insurgent/criminal networks in Iraq suggests several mechanisms that are consistent with this acceleration of violence. One theory -- that associated with the theory of third generation gangs, or the 3G2 model provides valuable insights as to the manner in which these groups are likely to evolve and the best methods to arrest their development.

Specifically, the 3G2 model suggests that armed groups function within a rationally bounded and organized space that is responsive to forces affecting the calculus and outcomes of group behavior. When modified by state authorities, these forces represent potential opportunities to minimize, deflect, or redirect the activities of the group.

Many of the structural conditions found in Iraq are key constructs of the 3G2 model. In particular, the existence of violent networks in the context of a

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state that is constrained by minimal capacity, poor economic performance, and significant social and political disparities are key elements of the model. The 3G2 model also assumes that self-protecting solidarity groups are heavily engaged in the informal and criminal economies at the local level. Insurgent/criminal networks in Iraq are analogous to the form and functions performed by street-level gangs -- the basic element of the 3G2 concept.

As the 3G2 model would predict, insurgent and criminal groups in Iraq have expanded their economic and political positions vis a vis the state through corruption and intimidation. Further the model posits that 3G2 actors themselves initiate this process for the purpose of establishing lawless areas and criminal enclaves or quasi-states.

On the other hand, certain causal relationships in Iraq differ from those posited by the 3G2 approach. In particular roles of local networks and the state are reversed. Starting with Saddam in the 1980s, the incremental decline of the capacity and presence of the Iraqi state, combined with the state-initiated scheme to retain power facilitated the expanded role the role of local-level groups. In fact, Saddam's approach during austere times was to compel local groups to fill the political and security vacuum produced by institutional retrenchment.

The process continued after Saddam's fall -- nearly all of the available political space with the exception of state-level ministerial portfolios had been effectively abandoned to local forces. In Iraq, the extent of corruption and intimidation exercised by insurgent and criminal groups has resulted from state retreat. As normally constructed the 3G2 model assumes criminal networks encroaching on the state.

The Iraq case suggests several modifications of the 3G2 model are necessary to better understand the dynamics unfolding in that country. In particular the end-state of the dynamic group processes currently underway are groups of lawless criminal enclaves or quasi-states stemming from the state's inability to provide essential social, economic and security functions.

On the other hand the present system may exhibit some stability. As the quasi-states take on the local functions of providing security and access to resources, they tend to favor a certain degree of stability and ever-increasing levels of market access. The competitive dynamic between these quasi states may produce a status quo that preserves the structure of the declining state. The state structure persists not in spite of the proliferation of quasi-states but precisely as a result of this process. This dynamic may explain some of the stability and security in Iraq in the absence of effective national government.

Oil and the Insurgency

A number of these mechanisms can be illustrated by the well documented patterns of interaction between the oil sector, government officials and the insurgency.⁵⁹

As noted above, oil smuggling became endemic in the 1990s when resource scarcity combined with government corruption combined to produce vast smuggling networks. The black market thrived, and informal business networks grew. Between 1991 and 2002, Iraq smuggled nearly 900 million barrels; between 1997 and 2003, Saddam's regime reaped more than \$8 billion in illicit oil sales.

During this period and despite enmity between their governments, oil smuggling networks grew between Iraq and both Syria and Iran, which continue to this day. Both governments benefited. The Iraqi government found a market in which it could bypass U.N. demands to spend revenue on humanitarian projects while the Iranian and Syrian regimes found both a cheap source of fuel and kickback income. The Pentagon estimated in 2000 that of the \$205 per metric ton cost for smuggled Iraqi oil in the Persian Gulf, \$95 went back to the Iraqi government; \$50 went to the Iranian Revolutionary Guard Corp's navy while the smugglers kept the remainder.

There was no shortage of market for smuggled oil. The official, government-controlled State Oil Marketing Company (SOMO) opened offices in Jordan and struck agreements with the governments of Iran, Lebanon, and the United Arab Emirates to facilitate oil sales. Buyers included organized crime networks from Somalia, Pakistan, and India, as well as brokers purchasing oil for coalition naval vessels patrolling in the Persian Gulf and enforcing the sanctions.

Smuggling networks persisted into the post-Saddam period. Rather than disrupt the network, the collapse of Saddam's government only drove it underground. The failure to install metering systems on oil flow facilitated corruption. Absent such metering, the real amount of crude oil either exported or smuggled remains subject to speculation.

The security vacuum following Iraqi liberation further bolstered opportunities not only for the existing smuggling networks but also for new criminal gangs. Just as Saddam used oil revenue to finance violence against the Iraqi people, so too have insurgents. Open borders facilitated smuggling, especially along the sparsely-populated Iraqi-Syrian frontier.

⁵⁹ The following draws heavily on Robert Looney, *The Business of Insurgency*, op. cit., and Bilal A. Wahab, "How Iraqi Oil Smuggling Greases Violence," *Middle East Quarterly*, Fall 2006.

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Several well documented cases illustrate the complex interrelationship between government officials, criminal gangs and the insurgency. In one notable case, the new Iraqi government signed (July 26, 2004) a deal to export crude oil to Syria in exchange for oil products. Over a three-week period in April 2006, Iraqi police seized 400,000 barrels of crude oil that was being smuggled into Syria. Within twenty-four hours, police at the Rabiya border crossing confiscated 1,200 smuggling tanker trucks whose drivers carried forged documents. The scale of smuggling suggests the complicity of both Syrian and Iraqi government officials. Dawud al-Baghistani, head of the Commission on Public Integrity in Mosul, told reporters that while the ring was connected to insurgents, the parties involved in the Rabiya smuggling included officials from customs and the ministries of oil, interior, and finance, as well as some private companies.

In another case demonstrating the confluence of officials, oil smuggling, and the insurgency, insurgents bribed government officials in order to access oil routes. Hazem al-Shaalan, who served as defense minister during the interim administration of Ayad Allawi, tasked Mish'an al-Juburi, a former parliamentarian and leader of an influential tribe in Iraq, to secure oil pipelines between Baiji and Kirkuk, an area which falls within the Al-Juburi tribal territory. Subsequently, Juburi was indicted for theft of several million U.S. dollars. Iraqi officials also suspect that he knowingly hired insurgents to infiltrate oil pipeline protection forces and shared profits with the insurgents.[20] It appears likely that Juburi, insurgents, or both bribed Shaalan to offer the original contract.

The profits insurgents reap from the oil trade are significant. Some estimate that insurgents pocket 40 to 50 percent of oil smuggling-generated revenue. Given an environment of high unemployment, low salaries, kidnappings, and murder, many Iraqis turn to the illicit economy to supplement income and provide for their families. In the absence of functional law enforcement, lucrative oil smuggling has replaced many small businesses.

Corruption has also compromised Basra, Iraq's second largest city and southern hub. Close to the Rumayla oil fields and linked by the Shatt al-Arab waterway to the Persian Gulf, it is a natural outlet for smuggling. A chief node in Saddam's oil smuggling operations, oil smuggling in Basra has only grown more overt since his fall.

The rivalry among various Shi'ite parties has compounded the problem. The Fadhila Party controls the governor's office as well as the oil industry in Basra. When new prime minister Nuri al-Maliki decided not to give the oil ministry to the Fadhila party when he announced his new cabinet in May 2006, the party threatened to stop oil exports. Had they not received benefits from

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their position, such drastic action would be unnecessary. A senior Iraqi oil official said that Fadhila sought kickbacks, and he blamed the unrest in Basra on the corruption and "power struggle between militias and mafias" within the ruling Shi'ite coalition.

Iraq's economy takes a second hit when Iraq buys refined oil. Because Iraq sells the imported fuel with huge subsidies, much of the refined product is exported back to the refining countries. The Oil Ministry's inspector general gave an example: throughout 2005, the Iraqi government has been selling diesel at the subsidized price of less than three cents a gallon, which could be sold for at least a dollar a gallon on the black market. Hence, a smuggler bringing fuel in a 9000-gallon truck from a neighboring country could make as much as \$7,450 even after paying generous bribes. Because the pipelines in no way benefit the insurgents, the lines have frequently been attacked to force the government to rely on trucks—a business already controlled by smugglers. Smuggling in fuel may have cost Iraq between \$2.5 billion and \$4 billion in 2005 alone.

The exploitation and diversion of oil resources hurts Iraq's economic, social, and political development. Oil smuggling places an enormous burden on state revenue and Iraq's economy. Up to 30 percent of Iraq's imported gasoline has been lost to smuggling networks, half of which is pocketed by the Iraqi insurgency. Had the Iraqi government invested this lost revenue in refineries, it might not need to import 60 percent of its refined oil needs. Not only have funds for vital projects been lost, but a portion of the missing revenue helps fund insurgency. Terrorism, in turn, hampers foreign investment. Attacking the oil pipelines could be a criminal enterprise but, regardless, insurgents benefit by extorting protection money from oil trucks. Terrorists and criminals have established a dangerous symbiosis. All these developments perpetuate instability and violence in Iraq.

How, then, can the Iraqi government break this cycle? First, the government needs to secure its borders. While the Coalition Provisional Authority and subsequent Iraqi governments have hired 22,000 border guards since 2003, this level is still below that needed to ensure security. Competence must also supplant sectarian, tribal, and political patronage.

While the Iraqi government, as demanded by the International Monetary Fund, has taken steps to lessen its subsidies, the continued discrepancy between the price of oil in Iraq and in neighboring countries provides the financial incentive for smuggling.

Maliki's government must also tackle the problem of bribery. Corruption permeates the Iraqi government from the top echelon of ministers to tribal

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chieftains and border patrol officers. Often, officials are the smugglers and are fully involved in the operation. If the new government can control bribery, then the incentive to turn a blind eye disappears at multiple points in the smuggling process.

While problems associated with subsidies and oil industry corruption may seem mundane amidst continued kidnapping and car bombs, until U.S. and Iraqi authorities manage to constrain Iraqi oil smuggling, violent crime and insurgency will continue to flourish.

State Decline – Criminal/Insurgent Expansion

In sum, despite the reverse causation between state decline and criminal/insurgent network expansion, many of the principals of the 3G2 concept are largely consistent with developments in Iraq. What do the modifications to the 3G2 for the Iraq situation suggest for that country's future?

- First, insurgent-group activity can be viewed as a cumulative effect of the structural forces prevalent in Iraq. The choice to engage in violence is one element of a strategic rationale formed by conditions of scarcity and the functions armed groups performs locally. This rationale also shapes the competitive dynamic that drives political and economic expansion.
- Second, the behavior of locally-based armed groups can be affected by manipulating societal and local-level factors, the most significant of which are: (a) economic conditions especially the growth of the informal economy, (b) competition between entrepreneurial and criminal/insurgent networks linked to the informal/shadow economies, and (c) the openness of the legitimate political sphere.
- Finally, these and other inputs into the 3G2 framework can be expected to generate certain outcomes stemming from group/network evolution from the street level.

The acceleration in violence in Iraq throughout most of 2006 suggests that the informal and shadow sectors will continue to dominate the economic landscape in the near term and will likely grow as the markets associated with insurgent violence expand. The criminal economies based on theft, weapons trading, mercenary kidnappings, black-market smuggling and arbitrage that have become the cornerstone of insurgent mobilization will continue to operate with very few constraints and will likely increase in proportion to increasing levels of violence.

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In the current phase, competition is actually fueling the expansion of the underground economy in addition to the increased appropriation of market segments by combatants. When viewed in the context of the 3G2 model, the structural setting presently observed in Iraq suggests the continuous and unconstrained expansion of insurgent group capabilities well into the future:

1. The tendency of insurgent groups to capture sectors of the growing informal and criminal economies will increase. This in combination with the growing political stature of armed groups and a liberalizing Iraqi state favors some type of criminal enclavization or quasi-state development in parallel to legitimate state structures.
2. Armed groups will function as the shadow or de-facto governments within these enclaves providing the services and performing the tasks reflective of their local orientation.
3. The structure of the legitimate Iraqi state will survive and may even thrive in those areas outside insurgent influence.
4. Locally-oriented armed groups can be expected to expand from the street to the sub-national level, evolving from mutually protective solidarity groups into prominent political and economic actors.

The degree of intensity of insurgent violence is increasing and this trend is likely to continue. Coalition forces confronting this challenge have been thrust into an environment of great uncertainty. Coalition forces on the ground are facing a variety of threats from across the spectrum of violent actors. The different motivations and relationships between these groups are gradually emerging:

- Indigenous and transnational actors are establishing links and magnifying their capabilities in ways that are consistent with the rapidly changing information-age environment.
- The traditional distinctions between violent groups seeking political goals and those pursuing profit are becoming blurred.

Summing up, an adapted version of the 3G2 model provides useful insights into the Sunni-led insurgency that the general guidelines currently in use tend to overlook. Those guidelines depict the insurgent threat as a discrete collection of actors motivated by a combination of nihilistic rage, primordial tribal grievances or a desire to restore the former grandeur of the Ba'th party.

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In contrast, the 3G2 model identifies the societal-level conditions affecting the origins, development and orientation of armed groups, the political role that these groups embrace over time and the relationships between groups that span the local, regional and global levels of interactions.

These factors culminate most forcefully at the street level, where the relationships between groups are characterized by violence and competition. The integrated model highlights certain critical junctures where these relationships can be altered and exploited to better combat the insurgency..

Strategies to Reduce Insurgent Violence

The integrated model shows that insurgent-group activity can be viewed as part of the continued effects of the structural forces prevalent in Iraq. The choice to engage in violence is one element of a strategic rationale informed by conditions of scarcity and the functions armed groups perform locally. This rationale also shapes the competitive dynamic that drives the expansion of insurgent groups into the political and economic realms. Therefore the behavior of locally-based groups can be affected by manipulating societal and local-level factors, the most significant of which are the size and composition of the underground/shadow economy and the openness of the legitimate political sphere. These areas comprise the key vulnerabilities of the insurgent/criminal groups in Iraq:

Resolving critical shortages and introducing balanced reforms in the formal sector will slow or reverse the growth of the informal and shadow economies. These measures would significantly undercut street level mobilization structures by co-opting the functions of tribal and sub-tribal groups while diminishing the pull of the shadow economy which fuels insurgent activity

Openness at the political level would similarly undercut or co-opt the rising political stature of armed leaders by channeling them into a legitimate political process.

Clearly, greater emphasis should be placed on limiting the growth of the informal and criminal economies, which are easily captured by criminal/insurgent networks. As noted above, Iraq's present set of economic policies are legacies of the CPA period. As in many other developing countries, they were intended to produce a thriving, free market economy. These policies reflect much of the reform agenda commonly known as the Washington Consensus, emphasizing fiscal discipline, re-prioritization of public expenditures, privatization, trade liberalization, deregulation, foreign direct investment, property rights and good governance in general.

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Three years later many of these reforms are only partially or haphazardly in place, contributing the expansion of the vibrant informal and shadow economies at the expense of formal sector development. One course of action is to try and press ahead with the completion of market reforms. However, given the current political atmosphere in Baghdad with so many government officials having a vested interest in preserving their lucrative links to black markets and the underground economy, this is unlikely to occur until major strides are made toward controlling corruption. Even price reforms will take time to begin slowing the growth of the underground markets. For example, while gas prices are gradually rising as part of an International Monetary Fund (IMF) program⁶⁰, the impact on the shadow economy has been somewhat due to the still prevalent oil price differential between Iraq and its neighbors.

Another approach is to re-introduce many of the pre-2003 state-based social services with emphasis placed on slowing or reversing the impetus to join the informal and shadow economies. These measures would significantly undercut street-level mobilization structures by co-opting the functions of tribal and sub-tribal groups while diminishing the pull of the shadow economy which fuels insurgent activity.

A variant on this course of action would be the reorientation of economic programs from the post-war centralized top-down orientation toward one that is decentralized and inclusive. This reorientation is likely to erode somewhat the popular or at least passive support for the insurgency – the more people with a stake in the decision making process and economic outcomes, the greater included in the decision making process.

As things stand in Iraq, many Coalition programs are not having much of an impact at the household level. The neoliberal reforms noted above are a top-town approach towards the economy, with often little trickling down. On the other hand many infrastructure projects carried out are not necessarily the ones the Iraqis themselves would have opted for given a significant input into the decision making process. While some employment is created by these projects none are really the part of an overriding development strategy geared to meeting specific objectives that the Iraqis themselves would have necessarily opted for.

In other words, there is a large disconnect with what goes on at the macro levels and at the project level. Part of this stems from the fact that the country has no real development strategy – documents abound, but none of these approaches the country's economic recovery and growth in a systematic, integrated manner. As result and because the Iraqis have had very little significant input into the process it is not clear that existing or proposed

⁶⁰ Robert Looney, "The IMF's Return to Iraq," Challenge 49:3, May/June 2006.

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programs are efficient in any meaningful way in meeting the average citizen's needs. For this reason many Iraqis feel alienated with little stake in the current system. The indirect stimulus from the neoliberal reforms is not impacting on their lives and the direct impact stemming from individual reconstruction projects is not sufficient to make significant impacts on their standards of living.

With these general guidelines in mind, it is possible to sketch out a economic development strategy in a manner consistent with the generation of equitable, sustained growth? If so what role might the Marines play at the local level? Briefly, three aspects of the reform program are critical:

First the strategy will have to incorporate the factors noted above that are likely to undermine insurgent/criminal groups in Iraq. Failure to do so will leave many local areas in the grips of violence, undermining any positive gains made in the economic/social areas. If the underlying determinants of the insurgency/criminal activities are not addressed and eliminated, programs in the economic/social/political area however well designed are doomed to failure.

Second, is there a credible approach that addresses the main deficiencies of neoliberalism? While the conventional wisdom at the beginning of the 1990s was that no credible alternative existed, that is no longer the case. Much of the current thinking on the factors needed for a successful development strategy come out of the experience of the Transition countries in the 1990s. The experience of transition shows that the neoliberal policies of liberalization, stabilization and privatization that are not grounded in adequate institutions may not deliver successful outcomes. As Professor Roland notes:

Thus there has been a shift in emphasis from markets and price theory to contracting and to the legal, social and political environment of contracting. Transition has not only helped to reinforce this change of focus in economic thinking, it has also renewed interest in thinking about the interplay and complementarities between the various constitutive institutions of capitalism. Finally, transition has forced us to think about institutions not in a static way, but in a dynamic way: how momentum for reform is created, how institutions can evolve but also how momentum can be lost, and how one can get stuck in inefficient institutions. In this sense, transition has reinforced what I would call the evolutionary-institutionalist perspective, insisting both on the environment of agents at any moment in time but also in its evolutions.

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⁶¹ Gerard Roland, "Ten Years After...Transition Economics," IMF Staff Papers 48 (2001), pp. 29-52.

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In Iraq's case, the most important differences between the two paradigms are no doubt related to their flexibility in adapting to unanticipated developments. For the Neoliberal approach, the political economy emphasis is, as was the case, in Iraq in 2003 to use early windows of opportunity of periods of "exceptional politics" to push reforms through as fast as possible and to create irreversibility.⁶²

The new institutionalists view this strategy as dangerous locking countries into inefficient economic structures that are hard to reverse because of the irreversibilities created. The emphasis is rather on ensuring a continuous and growing support for reforms among the population. This implies a more gradual and experimental approach to reforms, relying on the flexibility of experimentation with an adequate sequencing of reforms to possibly reverse reforms that do not work and try other ones.⁶³

Certainly a shift from the neoliberal paradigm to the new institutionalist model of development is called for in Iraq. However, given the large number of degrees of freedom, it makes the most sense at this point in time to simply sketch out a broad approach to reform. The presumption is that within this framework there is ample scope for modification, and while some measures might improve the likelihood of a liberal market economy eventually thriving in the country, implementing the complete set of actions is not critical in this regard. Instead, given the security situation and desire to combat the pull of extremists it is better to focus on a few high impact policies.

Third and building upon the new institutionalist model, Iraq's strategy will have to be one that is capable of creating a virtuous circle, with progress in one area creating incentives/pressure for progress in other areas. In short, economic programs, projects and reforms will have to be designed capable of creating sufficient momentum to overcome the physical, economic, demographic, networking and political impediments to growth. Here, corruption and the stake many have in maintaining the current system are particular obstacles. As long as the current set of reforms remain stalled, the more entrenched those opposing reforms will become.

Fourth, the various elements of the development strategy must interact as a coherent whole with each element reinforcing the others. Several key supporting elements stand out: (1) local financing through the creation of a series of microfinance institutions; (2) a dual-track strategy that focuses on both the development of the formal economy and the contraction of the informal segments of economic activity, (3) the reorientation of reconstruction

⁶² Gerard Roland, "Ten Years After... Transition Economics," IMF Staff Papers 48 (2001), pp. 29-52.

⁶³ Ibid.

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towards community development and (4) a reorganization of aid programs toward grants and rapid impact on the local community.

Fifth, implementation will no doubt be greatly assisted if several existing proven programs are expanded:⁶⁴

The Local Governance Project (LGP)

The LGP program represents an ambitious attempt at establishing democratic governance in Iraq. Specifically, the program's goal is the establishment of local institutions that are representative, responsive and capable of addressing citizens' needs and desires. To this end, the creation of social capital — the creation of links across different social, religious and ethnic groups is also a major objective of this program.

Commander's Emergency Response Program (CERP)

The purpose of the Commander's Emergency Response Program (CERP) is to provide commanders with a means to respond to urgent humanitarian relief and reconstruction assistance that can be implemented quickly and have an immediate impact on the Iraqi people.⁶⁵ This is a creative and important program designed to provide U.S. governmental appropriations directly to tactical units for the purpose of meeting emergency needs of local Iraqi civilians (a similar program exists in Afghanistan).

With most projects averaging \$50,000 CERP provides a quick and effective method that provides immediate, positive impact on the Iraqi people, while other larger reconstruction projects are still getting off the ground. The key to project selection is: (1) execute quickly; (2) employ many Iraqis; (3) benefit the Iraqi people and (4) may be highly visible.⁶⁶

CERP money can be used to meet various needs, including supplies, additions, to schools, clean-up projects, medical equipment, street lights, water towers and general reconstruction. Typical of the CERP program are: (a) 78 projects in the north district funded for \$4.9 million will add three classrooms each to 27 schools and six classrooms apiece to 51 schools; (b) in the Gulf Region Central District, an \$89,000 outpatient clinic is being built. Also in the central district, seven CERP projects for a cost of \$1.4 million are scheduled to replace low- and medium-voltage lines through Sadr City.⁶⁷

⁶⁴ Thanks to LtCol John P Boland (CE G5 G&E Econ Officer) for providing valuable insights and the basic documents pertaining to the current situation in Iraq.

⁶⁵ CERP Family of Funds: Fiscal Policies, Processes, and Standard Operating Procedures (Baghdad: Multinational Corps-Iraq, June 29, 2005), p. 2.

⁶⁶ Ibid, p. 4.

⁶⁷ "Construction Program Pumps Millions of Dollars into Iraqi Life," Nooz.com (July 27, 2005).

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Office of Transition Initiatives (OTI)

OTI's strategic objective, "political transition successfully advanced in priority, conflict-prone countries," is the basis for the short-term, flexible and rapid assistance it provides in transitional settings. OTI's support during transitions to peace and democracy and transitional political crisis has the potential to help create a strong foundation for longer-term targeted development programs. This program has been greatly under-funded, yet has the potential to play a critical role in Iraq, especially if it is closely coordinated with the in conjunction with LGP programs and the CERP.

Summarizing the proposed strategy:

1. Shifting from a neoliberal/Washington Consensus development strategy to one along neo-institutionalist lines as done in several of the Transition countries would reorient the development process in a manner encompassing more groups into the country's decision making and development process.
2. In contrast the neoliberal approach of relying on a whole spectrum of reforms, the neoliberal approach would shift attention to certain key areas critical to the building up of a momentum for further reforms.
3. Instead of the neoliberal stress on liberalization, stabilization and privatization, the evolutionary approach focuses on creating the institutional underpinnings of markets needed to insure strong entrepreneurial development.
4. While the neoliberal approach has focused on creating a clean slate by breaking up existing state structure, the institutional approach would attempt to use existing institutions to prevent further economic disruption and social unrest while developing new institutions.
5. A community development based development strategy fits into this general framework enabling Iraqis to participate in designing programs and policies in tune with their direct needs. The result would be better project selection, completion, and satisfaction, lessening the pull of extremist groups.⁶⁸
6. The community based strategy should be focused not just on deriving local development plans to be funded through redirected aid allocations. A key element of this strategy is to gradually repair the social capital

⁶⁸ The rationale for a community development oriented approach has been developed by Jason Ben-Meier. See his "Create a New Era of Islamic-Western Relations by Supporting Community Development," Strategic Insights III:4 (April 2004).

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- linkages destroyed by the previous regime. Starting at the local level and expanding to the region and eventually the national level, networks would strengthen not only the workings of the economic system, but also assist in the creation of a viable Iraqi state.
7. In shifting towards a community development based strategy, programs at the local level should build on three highly successful programs, but to date vastly under-funded: (a) the Commanders Emergency Response Program (CERP), (b) the Local Governance Project (LGP) and Office of Transition Initiatives (OTI).
 8. These three programs have largely operated independently, but should be closely coordinated and their orientation (mainly CERP) expanded to allow the funding of private sector projects. There is some evidence that there has been an over expansion in certain areas – schools, and other public sector activities. At this time the biggest impact per dollar will come from assisting the establishment of private, labor-intensive start up companies.
 9. Distributing a certain percentage of oil revenues to the Iraqi public through the creation of an oil fund, would provide added demand for a wide range of domestic consumer goods. Part of this payment to Iraqis could be made conditional on participation in local clean-up programs while short-term training programs were providing the skills needed by private companies.
 10. A Development Bank should be established, and funded by an additional share of oil revenues. This would be a temporary to allow time for the commercial banking system to gain the expertise to eventually perform this function. The bank would specialize in small loans to start-up companies, encouraging the participation of women in the economy.
 11. A goal of the newly created Development Bank would be regional balance with lending oriented toward a fairly even distribution of new firms across the country.
 12. Within this context, the shift to a dual track development strategy with a focus on supporting small-and medium-sized enterprises (SMEs) would draw many entrepreneurs out of the informal sector, further assisting in the creation of new firms and associated employment.
 13. Two areas of governance are critical for the private sector to take hold and thrive in Iraq: secure property rights and an improved rule of law. In the past deterioration in the rule of law and related institutional

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enforcement mechanisms has shifted the balance of incentives toward participation in the informal economy.

14. Improved macroeconomic stability will be critical in providing the right price incentives for private sector investment and activity. With growth inflationary pressures, the government will need to develop an improved stabilization tools, perhaps starting with an oil stabilization fund to better smooth out expenditures, avoiding short run bursts of disruptive austerity measures.
15. In Iraq's case, large allocations of assistance should be directed to two key areas noted above – small scale enterprise development and community development. Particularly in the case of community development the use of grants should be seriously considered. As the Meltzer commission observed, this provides a more effective means of monitoring projects and providing incentives to recipients.
16. Progress, as judged by annual independent audit, of stipulated outputs. This and other safe-guards might also help assure that community programs would not be taken over or reoriented by extremist groups.
17. Once the process is underway, several links between added employment and further demand creation would reinforce in a virtuous cycle-type mechanism the employment creation capability of the economy.
18. Most importantly, with the creation and expansion of a new class of entrepreneurs and those with a stake in seeing the reform process move ahead.
19. Further reforms, the reduction of corruption and the creation of and expansion of extended networks would build up the momentum to hopefully assure the viability and continuance of a liberal market economy.

Within this general strategy, a number of guidelines for Marine economic and reconstruction activities in Iraq become apparent.⁶⁹

1. Treat aid and economic development as short-term operational necessities until sufficient security and stability exist to give workable priority to longer-term efforts. Trying to build on longer term and more ambitious goals without a functioning short term foundation will simply lead to waste and failure. In economic terms this implies a very high time discount and may mean

⁶⁹ Based on Anthony Cordesman, "The Importance of building Local Capabilities: Lessons from the Counterinsurgency in Iraq," Draft, CSIS August 1, 2006, pp. 21-23.

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sacrificing projects with potentially higher long-term rate of returns, for activities that may never contribute significantly to longer term growth.

2. Give top priority to local jobs, local services, and efforts with immediate visibility and targeted impact on the local populace. Aid and development must actually benefit ordinary people directly, make the local government seem useful and credible, and show people that the US is actually helping. In stability operations and any form of conflict, perception will be as important as performance.

3. Focus on sustaining and expanding key sources of government revenue. Iraq and Afghanistan are scarcely new demonstrations of the fact that planning local forces and stability efforts that cannot be financially sustained by the host country rapidly develop serious problems in distorting the local economy and operations of the government. They also show in very different ways the need to rapidly help local governments develop or protect their sources of revenues.

4. Do not count on donor conferences and third party pledges of aid. Efforts to seek allied and international aid can be useful, but produce far more pledges and aid with strings attached than actual results and inevitably fall short of the requirement. The US must plan to pay for the aid efforts necessary to succeed.

5. Do not attempt ambitious efforts to restructure infrastructure unless these can be managed and implemented at the local level. The task will be to meet local expectations as much as possible on local terms and to avoid creating unrealistic demands and expectations. Small or medium sized efforts to fix and improve existing capabilities will go a long way toward building positive expectations and confidence in the local population.

6. Do not attempt to remake the national economy in mid crisis or wartime and only attempt major structural or sectorial change if the local government and people want it and can clearly sustain it. The US lacks the core competence to do this. It places an impossible burden on US forces and on the entire US mission and creates major new problems for local leaders.

7. Let local governments take the lead and make their own mistakes: Focus on reviewing and vetting requests for aid and ensuring they have suitable monitoring and fiscal controls. Iraq is only one of many case studies that show that the US is no better than local authorities at trying to undertake such large scale efforts and that the moment the US takes responsibility, it not only acquires the blame but finds it progressively harder to transfer responsibility

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back. By contrast advising, vetting, demanding suitable accounting and demanding measure of progress can be highly effective.

8. Do not rely on or use US contractors or other outside contractors unless absolutely necessary and by exception. The purpose of operations at both the political and economic levels will be to win local support and strengthen local capabilities. It will also be to get maximum operational benefits from the funds involved, and these will be heavily dependent on local employment and on the perception and the reality that aid efforts and projects meet local needs.

9. Provide US, allied, or local military security or do not attempt the effort; do not use mercenaries or private security details (PSDs) again. If the US is to commit major resources to stability operations, nation building and counterinsurgency, it must commit military forces to protect them, provide transportation, and provide support in high risk areas.

10. Accept the fact that some level of waste and corruption is inevitable and that meeting urgent needs on local terms has the higher priority. Bringing waste and corruption under reasonable control is necessary. Setting US standards, and giving anti-corruption and similar measures the same priority as success is absurd. Quite aside from the pressures and uncertainties of war and crisis, local standards of honesty and efficiency have to be accepted.

Taken as a whole these policy initiatives have the potential of not only significantly expanding domestic employment opportunities, but perhaps more importantly doing so through the creation of a virtuous cycle with feedbacks between the domestic market, further reforms and the labor markets (Figure 3).

Community development programs should be started and greatly expanded in those areas security permitting.⁷⁰ Local participation, project identification and implementation are the most rapid way to attack the current unemployment problems while reducing the insurgency threat. Iraqis must feel they have a real stake in the future and that it is within their control.

In terms of timing, the first priority should be to expand and build on existing, successful programs. While a number of these programs exist, the CERP program stands out and should have a significant increase in its funding. There is a growing consensus that if this program had had more funding all along we would not be in the mess we are now. The program should be

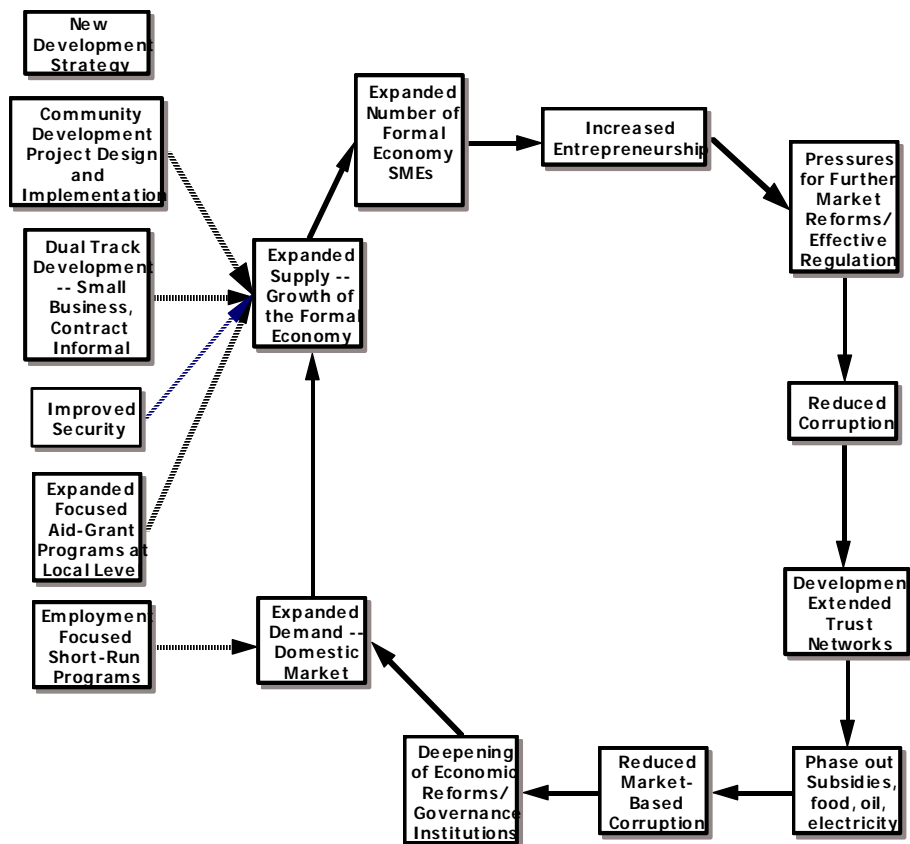
⁷⁰ The more than 200 Non-Government Organizations (NGOs) in Iraq have a constructive role to play in these situations. Cf. "Iraq: New Local NGOs Set to Play a Greater Role," (New York: United Nations, March 25, 2004).

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modified slightly to assure its support of overall community development programs. In addition, expanding CERP's scope to include the funding of private sector ventures would probably be the quickest way to obtain an immediate impact on Iraqi jobs and incomes. The capability exists in CERP for this broadened responsibility.

Figure 3

Iraq: Virtuous Circles to Restore Economic Growth/Combat the Pull of Extremist Groups



Second, the other two programs mentioned above, LGP and OTI, should also be greatly expanded and their efforts coordinated with the CERP. There has been a natural tendency for LGP and OTI programs to be absent from areas where security is an issue. Teaming them up with CERP is one way of extending their presence to areas of potentially high impact. The close coordination of these two programs with CERP could provide the needed security for the continuity needed to develop and implement quick action

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programs meeting the needs of the average Iraqi. However, the joining of forces of CERP, LGP, and OTI is not a natural one and will require some creativity in focusing the strengths of each on a common course of action – results will easily justify the effort.

Third, work is underway concerning the rule of law and property rights. This should be given a higher priority and additional resources for speedy resolution. The remainder of the programs noted above – Development Bank, Oil Fund, Dual Development/Informal economy credit programs can be gradually phased in as funding and personnel permit. They are needed programs to sustain the momentum built up by expanded CERP, LGP and OTI efforts.

In sum, the strategy outlined above have the potential of fulfilling the six overall conclusions of a recent Rand study concerning the effectiveness of social and economic development in countering terrorism recruitment⁷¹: (a) Social and economic policies can weaken local support; and (b) Social and economic development can discourage terrorist recruits. However, the Rand report goes on to caution that:

1. Social and economic policies inhibit terrorism only when they are funded adequately. As noted above, CERP allocations have been vastly undefended. Not only will the scope of CERP have to be expanded to include loans to the private sector, but its budget expanded to adequately meet local needs.

2. The ability of development policies to inhibit terrorism depends on their implementation. A major failure of implementation occurred in the Philippines where projects and programs were determined without comprehensive community based needs assessments. Here projects tended to focus on hi-profile initiatives that offered a quick return on investment—not projects that communities needed the most. In addition local corruption undermined the effectiveness of money spent. Clearly the community based program outlined above must be adhered to avoid a repetition in Iraq. Local accountability and thorough audits will be needed to reduce the ever-present problem of corruption.

Finally the Rand study goes on to caution that social and economic policies do not eliminate terrorism. Even if the community based development program makes progress at reducing the pull of extremism in Iraq, terrorism in that country will only be eliminated as part of a wider political and military strategy.

⁷¹ Kim Cragin and Peter Chalk, *Terrorism & Development: Using Social and Economic Development to Inhibit a Resurgence of Terrorism* (Santa Monica: Rand, 2003).

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Assessment

Recent research at the Naval Postgraduate School is suggestive of the types of the economic/social programs that are likely to be effective in jump starting the economy while simultaneously combating the insurgency in Al-Anbar province. Two themes that provide a synthesis for this varied body of academic research are the shadow economy and associated business of insurgency and the theory of third generation gangs. Combined they can explain why the country has become so unstable, spiraling down a path of reduced growth and increased violence. Conversely the models are also suggestive of certain actions that can reverse this decline and potentially set the country on a path of increased growth and reduced violence.

This synthesis provides insights as to what economic and insurgent patterns may evolve in the future. Specifically the existing system is highly unstable and prone to a vicious circle of reinforced violence and decline. In this scenario violence and the insurgency gain strength with time, but not enough to overthrow the central government. On the other hand the synthesis suggests the potential of economic programs and policy actions at the local level to create a framework conducive to the creation of virtuous circles of reduced violence and improved growth. In this environment the chances increase for success in combating the insurgency in al-Anbar improve dramatically. In this scenario, the Marines play a key role through their assistance in the implementation of strategic economic and social programs at the local level.